South Carolina Law Review

Volume 16 | Issue 4 Article 3

1964

Corporate Employee Retirement: The Economic and Tax Aspects of Qualified Pension, Profit-Sharing, and Stock Bonus Plans

Eugene L. Brantley

CORPORATE EMPLOYEE RETIREMENT: THE ECONOMIC AND TAX ASPECTS OF QUALIFIED PENSION, PROFIT-SHARING, AND STOCK BONUS PLANS

I. Introduction

The industrial growth being realized by South Carolina is fast bringing many economic changes to our state. The enactment of the new South Carolina Business Corporation Act[1] and the efforts of both state and local Industrial Development Boards have combined to lure foreign capital and talent into the Palmetto State. In addition to this influx of business, South Carolina talent and capital will increasingly be retained by the attractive business features offered to all business residents.

As a result of this healthy growth of business within South Carolina, the practicing lawyer will increasingly find himself confronted with business legal problems and estate legal problems which not so long ago were left to the so-called specialists in these fields.

Competition in the business world for qualified personnel and the retention of these people once acquired have given rise to a rapid growth and expansion of employee benefit programs. Such programs also lend themselves quite well to deferring federal and state income taxes for all participating employees.

This article will be devoted primarily to qualified pension, profit-sharing, and stock bonus plans as they affect the corporate entity and the individuals concerned.

More often than not, the lawyer comes into the picture after a bank trust department, an insurance agent, or the employees, through collective bargaining, have sold the employer on the establishment of a retirement plan. It is incumbent upon the lawyer at this point to thoroughly investigate the type of business which is being conducted, whether the corporation is solely owned or closely held, the benefit desires of the employer, the financial position of the business, the history of corporate profits in conjunction with the prospects for future profits, and last but not least, the real reason for the decision to establish such a plan.

This last point is most important to the lawyer if he is to gain maximum tax advantages for the business and covered employees. If the employer has an honest desire to establish

1. 12 S.C. Code (1962) (Supp. 1963).

a retirement program for all of his employees, the lawyer's task is greatly simplified. However, if the employer is seeking to cover only certain personnel and exclude others, the lawyer's work is cut out for him.

As a starting point it must be kept in mind that no retirement plan can be qualified under the Internal Revenue Code if it discriminates in favor of directors, officers, or highly salaried employees.[2] Once it is established that no discrimination is involved in the desires of the employer, the lawyer then can work towards determining which type of plan is best for his client.

II. QUALIFIED PLANS

A. PENSIONS

Naturally, there are advantages and disadvantages in each of the various types of retirement programs.

First of all the plan must be non-discriminatory,[3] permanent in nature,[4] and in writing.[5]

A pension plan is especially attractive to older employees because it takes into account, as a general rule, their past service to the business. Because they have fewer years of future service, these people naturally desire the security of fixed retirement benefits.

For this reason the corporation must decide just how secure the retirement benefits will be. Under a pension plan with a fixed formula for retirement, the employee will know exactly what he is guaranteed as retirement income and can plan his future accordingly. This security of retirement is a most important factor to be considered.

However, in order for the employer to be able to guarantee these fixed benefits, a fixed expenditure is incurred under this type of plan, and it must be met each year whether a profit is realized or not. Such a burden on a new corporation may well be ill-advised because of the morale affect on employees if a plan has to be discontinued for business necessity.

2. INT. REV. CODE OF 1954, § 401 (a) (3), (4), (5), and (6); See also Rev. Rul. 57-163, part 5, 1957-1 CUM. BULL. 68-107; 1961-2 CUM. BULL. 123-132. These two Cum. Bull. are a must for initiating plan drafts.

3. *Ibid.*

4. 26 C.F.R. § 1.401-1 (b) (2) (1954), as amended by T.D. 6675 (1963), 1963-2 CUM. BULL. 151.

5. 26 C.F.R. § 1.401-1 (a) (2) (1954).

There are five basic questions to be answered in the establishment of a pension:

1. WHO? This is in reference to who will be included in the plan or who the employer desires to be eligible for participation.

Since a pension plan is designed to systematically pay definite and determinable benefits to employees at retirement,[6] an employer should protect himself from covering those employees who are seasonal, casual, or part-time.[7]

There are several ways that this may be accomplished, the best of which seems to be a minimum age for coverage, coupled with a waiting period after becoming employed before the new employee may come into the plan. An example of this method would be to require an employee to be with the corporation full-time for a period of at least three years and have attained the age of twenty-one before becoming eligible for participation in the plan. In no case, however, can the waiting period exceed five years.[8] This device eliminates the *short-term* employees.

Requiring each employee to work a minimum number of hours each week or a minimum number of months each year before becoming eligible for participation will eliminate coverage of *part-time* employees.[9]

There are also methods that may be used to exclude certain other employees without having the plan labeled discriminatory. An employer may, for example, include salaried employees and exclude wage-earners, cover only the sales force, a certain factory, the office personnel, and may in addition, thereto, exclude all employees who earn below a certain annual income, provided a large percentage of the lowest paid employees are still eligible for inclusion.[10]

Once the short-term, part-time, and undesired classifications of employees have been eliminated, at least 70% of the remaining employees must be eligible in order for the plan to qualify.[11]

---

6. 26 C.F.R. § 1.401-1 (b) (1) (i) (1954), as amended by T.D. 6675 (1963), 1963-2 CUM. BULL. 151.
7. INT. REV. CODE OF 1954, § 401 (a) (3) (A).
8. *Ibid.*
9. Note 7, *supra.*
10. INT. REV. CODE OF 1954, § 401 (a) (5); 26 C.F.R. § 1.401-3 (1954).
11. Note 7, *supra.*

Furthermore, if the plan is contributory on the part of the employees, at least 80% of those eligible must participate in order for the plan to qualify.[12]

There is no specific number of persons necessary to qualify a pension plan. If a corporation has only one employee eligible, and the plan is non-discriminatory, it will qualify.[13]

The corporation may have its plan fail to qualify if there is any discrimination against "collective-bargaining" groups. It would seem that such would be allowed provided the purpose was to equalize the benefits between union and non-union employees, and between those members of a union covered under a union plan with those members of the union not covered under the union plan. Discrimination against any "collective bargaining" group may involve questions of labor law as well as tax law.

When attempting to determine whether or not the corporation's desire is *bona fide* in setting up a pension or profit sharing plan, a close look should be made to see if there will be covered only family members, outside attorneys, outside accountants, or other persons employed by, but not directly assiciated with the firm.[14]

2. WHAT? Once the plan is determined to be non-discriminatory, counsel must then look to the amount of compensation to be awarded and the formula to be used in reaching this award.

When past service is being given consideration in the formula to be used, it becomes necessary to know the history of the corporation's existence. All employees may be given due credit for their service to the business from the first day of employment. This is not true, however, of sole proprietors, or partners of a partnership prior to the date of incorporation. Partners and sole proprietors prior to incorporation are not considered employees, and their past service for qualified plans may be counted only from the date of incorporation.[15]

The amount of compensation presently being received must also be reasonable or the corporation may not be allowed a deduction for the full amount of compensation paid to an

12. *Ibid.* See also Rev. Rul. 61-157, part 4 (m), 1961-2 CUM. BULL. 85-86.
13. Rev. Rul. 55-81, 1961-2 CUM. BULL. 392.
14. Rev. Rul. 61-157, part 2 (e) (4), 1961-2 CUM. BULL. 72.
15. Rev. Rul. 61-157, part 2 (e) (1), 1961-2 CUM. BULL. 71.

employee. If an employee's salary has been challenged by the Internal Revenue Service as being unreasonable, that portion which has been disallowed should not be used as part of the "compensation formula." An employee's compensation seems to be the most used method of arriving at a reasonable retirement income, and where the corporation is losing a partial deduction for present over-compensation, likewise will it lose a partial deduction for contributions to the retirement plan based on the excess compensation.[16]

The "compensation formula" has many advantages to both the corporation and employees. First of all, it allows the highest paid employees, usually management and sales personnel, to receive the majority of benefits from such a plan. Secondly, it encourages the lower paid employees to compete for better corporate positions because with each promotion, the employee's retirement income is increased.[17] Thirdly, and most importantly, it allows the employee to retire on an income based on the standard of living to which he had become accustomed.

This is not to say that the corporation should attempt to fund an employee's retirement at 100% of his highest salary or last year's income prior to retirement. The purpose of such a plan is to ease a great sociological and economic problem for both the employer and employee, while at the same time tying the employee closer to the corporation and fulfilling a moral obligation to him. For these reasons, a percentage of income based on the average earnings from his five highest salaried years of service to the corporation seems quite plausible.

In reaching the desired percentage of income to be paid at retirement, it further becomes necessary to include Social Security benefits at this planning stage. Basically, the corporation is already funding a portion of the employee's retirement each time it pays Social Security Taxes. Integration of these retirement benefits into the proposed plan will give the employee a more realistic retirement income while lessening the burden on the corporation. An integrated plan which combines Social Security and Pension benefits to retire an employee with 40%, 50%, or 60% of his average earnings over

16. See 26 C.F.R. § 1.404 (a)-(3) (b) (1954).
17. See Rev. Rul. 61-157, part 5 (m), 1961-2 CUM. BULL. 93.

the five highest salaried years of his employment should well satisfy the purposes of such a plan.[18]

The "past service" feature of a plan at its inception is a great offset for the older employees of the corporation. The younger employees will naturally be taken care of through future service, but recognition of past services in the formula will increase the pension of those nearing retirement and will better employee-employer relations.[19]

At this point it is well to point out that a pure pension plan is designed only to fund an employee's retirement—nothing more, nothing less. If he quits or dies prior to retirement, no benefits are paid. When he dies after retirement, the pension ceases. In a pure pension plan it is quite simple to determine the funds needed, based on mortality tables and compound interest, to accomplish this corporate desire.

However, there are many other benefits that may be included in a pension plan which make it more attractive and plausible. Such benefits are called *supplemental* benefits and will naturally increase the cost of the plan. It is necessary that these benefits be non-discriminatory the same as the basic plan in order for the corporation to receive favorable tax treatment thereon. Supplemental benefits must be *incidental* to the main purpose of the plan[20] and these include:

(a) *Disability Payments*—As a general rule only large corporate pension plans include disability benefits due to the cost factor. Smaller corporations may well do better to carry separate commercial Accident and Sickness type policies for salary continuation on certain classifications of employees. Such policies carried on certain personnel as a classification will separately qualify for favorable tax treatment,[21] while at the same time ease the corporate obligation to these people during the period of disability. This type of person naturally is costly to replace, and during a period of disability the corporation normally would continue his income out of future profits while awaiting his return to work. On the other hand,

18. See Rev. Rul. 61-157, part 4 (j) (1) and (2), 1961-2 CUM. BULL. 83-84. These two sections lay out the integration rules and benefits derived therefrom.

19. See Rev. Rul. 61-157, part 5 (r), 1961-2 CUM. BULL. 94. When there is a minimum age and service requirement, a plan which credits past service of original participants but does not so credit past service for those entering later, may be discriminatory.

20. See Rev. Rul. 61-157, part 2 (i), 1961-2 CUM. BULL. 73.

21. Such a plan would probably not qualify under § 401, but should qualify as a business expense under § 162 of the Code.

the laboring class would be easier to replace and the cost of including all these people under a disability benefit of the pension plan of a small business may not be feasible.

The larger corporations may well be able to afford such a benefit and, if so, it would be to the benefit of the corporation and employees to include it.

An employee is allowed to receive up to $100.00 per week income-tax-free under a qualified disability plan when paid for reasons of disability.[22] However, it may be wise to forego disability payments to any employee with less than a certain number of years employment or under a certain age. An example of such an eligibility requirement would be that only those employees who have attained 50 years of age or have been employed for at least 15 years will qualify for disability benefits. This requirement will reduce the cost while providing for those employees to whom the corporation would most likely feel obligated and who would be in need of such a benefit.

Disability payments should furthermore cover the necessities of the employee during a period of disability. Extreme caution should be exercised in the selection of a disability benefit formula so as not to encourage an employee to "ride sick-call", so-to-speak, and not desire to return to work. Quite naturally, if an employee has no real "financial" motivation for returning to work, his "mental" recuperating process may be greatly hindered.

Coupled with a carefully selected benefit formula should be a direct monitor of the employee's physical condition during his period of disability. If the plan is non-insured, company physicians or company appointed physicians should periodically examine the employee to insure his return to work at the earliest possible date. If the plan is insured, the employee will be required to meet the disability tests as designed by the insurance company, and this relieves the corporation of a great burden as to deciding whether or not the employee is truly disabled. Since the insurance company has assumed the burden and risk involved, the corporation should not intervene unless it is obvious that the insurer is taking advantage of the employee.

22. 26 C.F.R. § 1.105-4 (d) (1) (1954); See also INT. REV. CODE OF 1954, § 105 (d) and § 106. See also Rev. Rul. 62-152, 1961-2 CUM. BULL. 126, expressing various limitations on disability benefits in an integrated plan.

(b) *Vesting*—A vesting schedule in a corporate pension plan may well be described as a pension prior to retirement, but it also serves many other valuable purposes.[23]

First of all, it has already been pointed out that a corporation should not even attempt to include short-term employees. However, once an employee is eligible for coverage under a pension plan, the corporation may well find itself subject to a civil action and in trouble with the Internal Revenue Service for terminating employment or pension payments without cause in order to deny an employee his retirement benefits.[24]

On the other hand, there are many instances when it becomes necessary to discharge employees, the reasons for which are quite sound. Even then, it seems quite appropriate to provide severance pay unless the cause of termination has been completely on the part of the employee. When severance is due to a change in business conditions and severance pay is deemed abvisable, it naturally must come out of current expenditures and income. However, a vesting schedule within a corporate pension plan may well serve this purpose.

Like any other supplemental benefit, vesting schedules vary widely. It would appear, however, that the most workable plan for the corporation would be one which entices the employee to remain. For example, a schedule which allows 25% vesting after 5 years of service, 50% after 10 years of service, 75% after 15 years of service, and 100% after 20 years of service would tend to keep the employee striving to complete short periods of service and not to concentrate just on his "old age."

Many differences of opinion also arise during the course of employment which may breed thoughts of quitting on the part of the employee. A vesting schedule could prove very valuable in such a case. For example, if such an event occurred after 9 years and 3 months of employment, the employee would hardly walk out at that point and deprive himself of this extra money when all he has to do is remain for nine more months and capture a sizeable sum. More often than not, after nine months he has forgotten his grievance and is back in the "fold." This is known as buying "time" for management.

---

23. See Rev. Rul. 61-157, part 5 (c), 1961-2 CUM. BULL. 87-88.
24. *Ibid.*

Although the pension plan must be primarily designed for retirement only, periodic vesting of interests in the employee in employer contributions to the plan shows a concrete recognition of services already rendered to the corporation and improves the morale of employees.

One important factor in vesting schedules with respect to close corporations is that the vested interest should be based only on years of *participation* in the plan rather than years of service to the business. This precludes immediate turnover and business destruction of a small corporation where credit has been given for past service.

(c) *Pre-Retirement Death Benefit*—The maximum allowable death benefit, and that usually recommended, is 100 times the monthly pension at retirement, figured at the date of death.[25] For example, if an employee was scheduled on the date of his death to receive $100.00 per month retirement income, his death benefit would be $10,000.00.

It should be noted that such benefits, even though the employee is allowed to name the beneficiary thereof, are not included in the gross estate of the employee for Federal Estate tax purposes.[26]

(d) *Pre-Retirement Widows' Benefits*—The plan may allow the widow of a deceased employee to receive a percentage of what the employee would have received at retirement. However, such a benefit should be paid only if the employee has served the corporation a minimum number of years or attained a certain age, for example 10 years of service or age 40.

(e) *Post-Retirement Death Benefits*—As a general rule, the death benefits for employees cease at retirement when the employee begins to receive retirement income. However, there are certain income options that should be available to the employee to provide continued income for the family of the employee after his death. By taking a reduced pension the employee may guarantee that the pension will continue for a certain number of years[27] or for the life of his widow after his death.[28]

25. Rev. Rul. 61-157, part 2 (d) which states that more than the recommended 100 times factor may cause the death benefit to be more than *incidental.*
26. INT. REV. CODE OF 1954, § 2039 (c).
27. Period certain option. See Rev. Rul. 61-157, part 5 (n), 1961-2 CUM. BULL. 93, which allows option discretion in *trustees* also.
28. Survivorship option.

(f) *Lump Sum Or Interest*—The employee may be allowed to receive his retirement benefits in a lump sum[29] in lieu of monthly income and if so, it will be treated as capital gains.[30] The pensioner may also be allowed to receive only the interest earned by this lump sum figure,[31] preserving the corpus for his family.

All of the above benefits can be varied to suit the corporate needs and desires. The plan, however, must have been in effect for at least ten years for any highly salaried employee to retire on a full pension.[32] If his service is less than ten years or if the plan has been in effect for less than ten years upon his attaining the prescribed retirement age, he may be allowed to receive a reduced pension and retire.

3. HOW? The *how* of a pension plan refers to the amortization basis and investment method to be used in order to have the capital needed for the retirement of the participants. The guarantee of a fixed retirement naturally depends upon the safety of investment and dependability of return thereon.

Since pensions are long range propositions and the retirement income is specifically laid out for the employees, there is an absolute requirement that sufficient funds be available to do the job.

Basically, the two funding methods used are the *insured* and *non-insured.* The one selected may depend on the number of employees covered but this is not always controlling.

It is safe to say that it would be unwise for the small corporation to attempt self administration of a non-insured pension or profit-sharing plan without expert outside assistance.

There are six major factors to be considered in determining the method of funding to be used:

1. The most important, of course, is a guarantee that the necessary funds will be available.[33]

29. Rev. Rul. 61-157, part 5 (n), 1961-2 CUM. BULL. 93.
30. 26 C.F.R. § 1.402 (a)-1 (1954), as amended by T.D. 6483, 6497 (1960), 1960-2 CUM. BULL. 19 and 932 and T.D. 6676 (1963), 1963-2 CUM. BULL. 41.
31. Interest only option.
32. 26 C.F.R. § 1.401-4 (c) (2) (1954), as amended by T.D. 6675 (1963), 1963-2 CUM. BULL. 151. Even if the plan has been in effect for ten years, the full "current" cost must be funded.
33. Rev. Rul. 61-157, part 2, (f), 1961-2 CUM. BULL. 72. A qualified plan must be a funded plan. However, employer contributions may be deferred so long as they do not amount to a termination of the plan in accordance with part 5 (f) of this ruling.

2. The cost of guaranteeing this availability when a non-insured plan is used.

3. The non-insured plan may, but not necessarily always, give a slightly higher interest yield and the expenses are paid as they occur.

4. Trust companies may invest in common stocks and equities and although the yield may be higher, the risk is greater.[34]

5. Insurance companies are generally restricted from investing in common stocks and equities.

6. The insured plan has pre-paid expenses which may cause a slightly lower interest yield, but will definitely guarantee the pension.[35]

Individual policies are not necessary for each participant although they may be used.

The three basic plans of pension administration are:

1. *Group Annuity*—This is often referred to as the "brick method," whereby the corporation annually purchases a small annuity on each participant as his pension income requirement increases. This increased requirement is brought about by current salary increases, and by adding a little at a time, sufficient annuities will be available at his retirement.

2. *Deposit Administration*—By this method the money is invested annually, and at retirement an annuity is purchased from the capital on hand. This type of investment may also be handled by an insurance company in order to guarantee the availability of capital.

3. *Pension Trust*—The trustee handles all investments of funds, and expenses of the administration are paid each

34. See Rev. Rul. 62-183, 1962-2 CUM. BULL. 143 holding that state banks, national banks, savings and loan associations, or building and loan associations properly chartered and subject to Federal or state regulatory requirements whose deposits are covered by the F.D.I.C. or F.S.L.I.C. are not engaging in a prohibited transaction when they take their own deposits in an employees' trust account. Such a transaction is merely a deposit and is not a loan even though the grantor bank is the account trustee.

35. Since a pension plan is based on actuarial assumptions to provide fixed, determinable, and definite benefits, any excess in forfeited funds, dividends, credits, or actuarial errors can not revert to the participants, but must be applied to reducing the next deposit or deposits thereto. Rev. Rul. 61-157, part 3, 1961-2 CUM. BULL. 78-80. Only upon complete satisfaction of liability to all beneficiaries may the excess revert to the corporation-grantor.

year as they occur. If the investment yield can be greatly increased, the cost to the employer will be decreased.

4. WHEN? We now are concerned with the dates on which benefits will accrue or be paid.

Normally retirement benefits are based on corporate policy, and may be influenced by other factors such as Social Security. Since Social Security benefits accrue at age 65, this seems to be the most popular date for retirement benefits to be paid. However, a corporation may select any age that it desires so long as all other requirements are met[36] and the retirement age does not exceed 70½. Early retirement on a reduced pension,[37] increased pension income for employment beyond the normal retirement age,[38] and other supplemental benefit *whens*[39] as previously discussed may be included in the plan.

5. CONFLICTS OF INTEREST—In arriving at a satisfactory retirement plan, counsel must remember the various interests to be served while assisting the corporation.

The corporation naturally wants to keep its cost at a minimum; the employee wants as many benefits as he can possibly demand; people with more years of service feel that they deserve more than newer employees; the higher paid employees feel that they deserve more than the lower paid employees; and there is the age-old conflict between male and female employees. The older employees see retirement just around the corner and want fixed benefits immediately, whereas the

36. See Rev. Rul. 61-157, part 5 (h), 1961-2 CUM. BULL. 91. Normal retirement age should conform to that of the company or industry, and an earlier retirement than 65 may not be used merely to accelerate funding.

37. REV. RUL. 61-157, part 5 (i), 1961-2 CUM. BULL. 91. Any reasonable optional early retirement age will generally be acceptable provided, however, that if the employer's consent is required, the value of the early retirement benefit does not exceed the value of the employee's vested benefits at that time. If the optional early retirement age is earlier than 65 (60 for women), and if integration with old-age, survivor's, and disability insurance, or with the benefits under the RAILROAD RETIREMENT ACT, is involved (see part 4 (j) hereof), the benefits must be appropriately limited. See 1961-2 CUM. BULL. 140, or 1953-1 CUM. BULL. 292 whichever is applicable. If early retirement is due to "disability," the term must be defined in the pension plan. See 1961-2 CUM. BULL. 93.

38. Rev. Rul. 61-157, part 5 (j), 1961-2 CUM. BULL. 91. Once the normal retirement age has been reached, provisions may be made to treat the pensioner as if he is actually retired, defer to actual retirement without increment for the interval between normal retirement date and actual retirement date, or accrue additional benefits on account of continued service provided such provision is uniformly applied and non-discriminatory.

39. *Supra,* part II, A. 2. (a)-(f).

very young employees can not comprehend reaching age 65 and would prefer to gamble more.

If the plan is *non-contributory* the corporation will cover all employees that it desires covered, the plan is easier to qualify with the Internal Revenue Service, unions prefer a

In studying these conflicts, counsel should know whether or not the employee is to contribute to the plan for an increased pension.[40]

non-contributory plan, the supplemental benefits are designed to suit the corporation, the tax status is more favorable since employees must pay income taxes on the amount of their contributions to a contributory plan, and the corporation has more leeway in selecting the method of funding.

If the plan is *contributory*, the corporation must sell at least 80% of those eligible on coming into the plan,[41] young people with low incomes will be contributing money which possibly may be better used for personal insurance and other needs, employee demands will be greater as far as supplemental benefits are concerned, employees will get larger pensions, employees will tend to read and better understand something in which they invest, investment of the fund will be more conservative, employees are forced to save money which may serve as an emergency fund, and employees may have a bigger voice in who is to be covered.

When employment is terminated under a *contributory* plan, the employee will get his investment[42] and his interest in

40. See Rev. Rul. 61-157, part 5 (h), 1961-2 CUM. BULL. 83. *Voluntary* employee contributions of amounts up to 10% of compensation are permissible provided employer contributions are not geared to employee contributions. Voluntary employee contributions must be used only to provide additional benefits. However, *compulsory* contribution percentages must not be so burdensome as to be discriminatory.

41. REV. RUL. 61-157, part 4 (b), 1961-2 CUM. BULL. 81. See also part 4 (m) of the same ruling which allows the percentage requirements to drop below the prescribed factors provided the minimum percentage is met on at least one day during each quarter of the taxable year.

42. See Rev. Rul. 61-157, part 2 (i), 1961-2 CUM. BULL. 73. No interest is allowed on *voluntary* contributions either upon withdrawal or in computing benefits at retirement. A definite distinction is made between *compulsory* and *voluntary* contributions on the part of employees. There can be absolutely no withdrawal of *employer* contributions prior to retirement under a pension plan except the vested interest, and then only upon severance or termination of the plan. Neither can there be withdrawal of *compulsory* employee contributions because these, along with the corporate contributions, are actuarially computed to provide the basic benefits of the plan itself, and the only primary purpose for such a plan is to fund retirement. All other benefits may only be incidental thereto. Short term *loans* may be made, but only up to the amount of the vested interest. See note 61, *infra*.

the corporate contribution based on the vesting schedule if one is provided. If there is no vesting, or if there are forfeited funds due to termination of employment, such funds *must* be used to reduce the cost of the plan for the corporation at the next accounting date.[43]

Initially, especially if past service is credited, there may be a large capital outlay by the corporation to establish the plan. However, the initial shock or burden is lessened by allowing the corporation to spread its funding of other than current cost over a period of years. In no case can the corporation deduct more than 5% of the current participant payroll as contributions to fund the current cost of the plan.[44] The corporation may, however, deduct up to an additional 10% of said payroll in order to fund the cost of past service.[45] This means that the corporation may never deduct more than 15% of payroll for contributions, but may spread out the funding in order to take advantage of lean, as well as fruitful, business years. In fact, employer contributions may even be completely deferred provided that the corporation is obligated to pay the full amount of the stipulated benefits to each retired employee-participant after the funds in the trust forming a part of the plan have been exhausted.[46]

B. PROFIT-SHARING[47]

Basically, the WHO, WHAT, HOW, and WHEN are the same in profit-sharing plans as they are in pensions, but the approach may vary.

The *purpose* of a profit-sharing plan will set the eligibility requirements. As has been stated, a pension plan has as its

43. REV. RUL. 61-157, part 5 (d), 1961-2 CUM. BULL. 88. Benefits which are forfeited due to termination of employment or for other reasons cannot be allocated to the remaining participants because a pension plan is based on definite and determinable benefits. If forfeitures were so distributed it would amount to increasing a participant's benefits above that actuarially computed to fund his retirement. See also part 2 (o) of this ruling which prohibits the creation of a contingency or surplus reserve.

44. 26 C.F.R. § 1.404 (a)-4 (a) (1954), as amended by T.D. 6534 (1961). For the second year after installation of the plan and every fifth year thereafter, actuarial data must be filed in order to substantiate the contribution as being needed in order to fund the plan. Mortality and compound interest tables will be used by the Internal Revenue Service to determine whether or not the corporation is deducting more than is necessary.

45. INT. REV. CODE OF 1954, § 404 (a) (1) (C).

46. Rev. Rul. 61-157, part 2 (f), 1961-2 CUM. BULL. 72.

47. See Bruton, *Profit-Sharing Plan,* 5 S.C.L.Q. 201 (1952). This article provides an excellent summary of the business advantages and tax aspects of such a plan.

primary purpose the retirement of employees, and any other benefits are incidental to this purpose. A profit-sharing plan, however, may be solely to provide severance pay, to provide a form of ownership in the business, to provide a retirement fund, or a combination of any of the above.[48] If, for example, the plan is for a retirement fund, the waiting period prior to becoming eligible may be longer than that in a plan designed to provide severance pay or ownership.

As in pension plans, there must be no discrimination if the corporation is to gain favorable tax treatment. In addition to this requirement there must be a definite predetermined formula for allocating the contributions among the participants and distributing the funds at a prescribed time.[49] Since only profits are to be used, there is no guarantee of any benefits ever accruing under the plan. Even in good years, the corporation is limited to contributions equal to no more than 15% of the corporate payroll of those employees participating in the plan.[50] This means that a maximum corporate deduction of $7500.00 would be allowed to a corporation having ten participants in its profit-sharing plan if each is salaried at $5000.00 annually.

There is, however, a "carry-forward" provision which allows a corporation which has had a non-profit year, to carry forward the deduction to the following year if profits so allow the contribution.[51]

Affiliated corporations, some of which may have a steady non-profit history, may spread profits around so as to benefit all employees of the other corporations.[52]

Some profit-sharing plans may allocate profits among the employees according to age and length of service. However, past service *generally* is not considered in such a plan's formula. Direct compensation, not including bonuses, generally is the pri-

48. See 26 C.F.R. § 1.401-1 (b) (1) (ii) (1954). A profit-sharing plan is a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries.

49. 26 C.F.R. § 1.401-1 (b) (1) (ii) and (b) (2). Although there is a requirement for a fixed formula once profits have been contributed, there is no requirement for a corporation to contribute the same ratio of profits each year nor to contribute any sum each year. However, merely making a single or occasional contribution out of profits does not establish a profit-sharing plan. *To be a profit-sharing plan, there must be recurring and substantial contributions out of profits for the employees.*

50. INT. REV. CODE OF 1954, § 404 (a) (3) (A).

51. See 26 C.F.R. § 1.404 (a)-9 (d) (1954). This "carry-forward" provision allows a corporation to average the primary contribution limitation of 15% of payroll.

52. 26 C.F.R. § 1.404 (a)-10 (1954).

mary basis for allocation of the profits.[53] Quite like the pension plan, the higher salaried employees will receive the larger benefits if there are any to be received.

There are no definite fixed benefits to be guaranteed by a profit-sharing plan, but neither is there a fixed liability on the corporation in lean years.

Profit-sharing appeals to the newly formed corporation and to the younger employees of an established firm as well. Knowing that retirement is many years away and that benefits will be directly proportionate to the effort expended in assuring corporate profits each year, young people are attracted to such a plan. The older employees, on the other hand, usually do not like this insecurity.

The plan must not be temporary in nature. It must be a permanent plan[54] designed for perpetuity, and it must be appropriately communicated to the employees.[55]

There is no ten year requirement for a pension to retire under a profit-sharing plan. He merely retires on his portion of the fund. For this reason, there is a requirement for "tight" vesting of benefits in order to make it attractive.

Once profits are allocated to the fund, they may be invested through a life insurance company to earn a guaranteed interest yield and have safety of capital, or they may be placed in trust in order to seek a higher interest yield.[56] This fund, even if in trust, may be partially invested in *ordinary* life insurance so long as no more than 50% of the corporate contributions are invested in insurance premiums.[57] This is a favorite method of providing pre-retirement death benefits which are not included in the gross estate of the employee.[58] Due to the volume of insurance, ready future business, and low agent commissions, the insurance companies provide a full reserve type of *ordinary* life insurance for these plans which have first year and higher than normal later year cash values. For these reasons, the in-

53. INT. REV. CODE OF 1954, § 401 (a) (5) provides that *total* annual compensation may be used in determining benefits provided this is uniformly applied, and this includes bonuses.

54. See Rev. Rul. 61-157, part 2 (p), 1961-2 CUM. BULL. 75-76.

55. REV. RUL. 61-157, part 2 (k), 1961-2 CUM. BULL. 74.

56. See 26 C.F.R. § 1.401-1 (b) (5) (i) (1954). Local law determines the restrictions on investment of trust funds.

57. Rev. Rul. 61-157, part 2 (d), 1961-2 CUM. BULL. 70-71. The insurance must be converted to cash at or before retirement, or provide periodic income payments with no life insurance feature after retirement, or be distributed to the participant.

58. INT. REV. CODE OF 1954 § 2039 (c).

vestment feature is even more attractive than in most life insurance.

There may be employee contributions to a profit-sharing plan in order to aid retirement, but, as in a pension plan, there must be 100% vesting in such contributions.

One problem with profit-sharing plans, due to required tight vesting, is the attitude of employees after a number of years of participation. Seeing a large sum of money growing in their behalf and not having immediate use thereof, may often breed restlessness and a desire to withdraw the funds. This, of course, would defeat the purpose of the plan and destroy its value.

Employees may be allowed to withdraw money from the fund provided that the lowest two-thirds of the salaried participants do not withdraw more than 50% of their portion of the fund.[59] If such does happen, the plan becomes unqualified.

In drafting withdrawal provisions there should be a minimum participation period before any withdrawals are allowed. Even after this requirement has been met, withdrawals should be limited to a percentage of the participant's vested interest and allowed only for emergencies, the determination thereof to be placed solely in a committee made up of participants and management.[60] The committee must naturally be lenient in determining whether or not an emergency exists, but this will at least place some control over these withdrawals. Even if there is a withdrawal, it should be made only as a loan to be repaid in a short period of time at a specified interest rate.[61] The interest rate, if one is used, should be lower than the prevailing rate of interest of lending institutions since the employee is borrowing his own money for an emergency.

A profit-sharing plan is a form of deferred compensation which is owned by the employees. For this reason, the employees should have a voice in the investment of the funds as well as any supplemental benefits to be paid. Such employee partici-

59. See Rev. Rul. 56-693, 1956-2 CUM. BULL. 282, modified by Rev. Rul. 60-323, 1960-2 CUM. BULL. 148.

60. See Rev. Rul. 61-157, part 5 (o), 1961-2 CUM. BULL. 93-94. Whereas there may be no withdrawals of employer contributions from a pension fund, withdrawals may be allowed from profit-sharing and stock-bonus funds for "hardship" reasons provided the term "hardship" is defined in the instrument, the rules apply uniformly, and withdrawals do not exceed the participant's vested interest.

61. REV. RUL. 61-157, part 5 (q), 1961-2 CUM. BULL. 94. Loans of an amount not in excess of the vested interest may be allowed in all qualified plans. However, these loans may be treated as "distributions" if there is a tacit understanding between the parties that collection is not intended.

pation in policy decisions further strengthens the plan and cements employee-employer relations.

Should death benefits from insurance be paid prior to retirement, any remaining interest must be allocated proportionately among the surviving participants to increase their interests.[62] The corporation will in no way directly benefit as it would in a pension plan by having its cost reduced.[63]

Lump sum benefits paid at retirement are treated as capital gains, the same as in a pension plan.[64]

Since the profit-sharing plan is designed to allow employees a share of the business, "tight" vesting of benefits is required. This is not to say that these benefits cannot be forfeited by the employee. Complete long-range forfeiture provisions may meet close scrutiny, but reasonable forfeiture clauses in the event of voluntary termination or involuntary termination for cause would appear to be satisfactory.[65]

C. COMBINATION INSURED AND NON-INSURED PLAN

One of the most popular investment devices used today in pension and profit-sharing plans is a combination of an insured and non-insured plan. This is especially good where pre-retirement death benefits are involved.

A portion of the contributions in a pension or profit-sharing plan is invested in the type of ordinary life insurance previously discussed.[66]

If it is a *pension* plan, an amount of the contribution necessary to purchase one-hundred times the monthly pension[67] in this type of insurance is so invested. If it is a *profit-sharing* plan, an amount equal to 50% of the employer contributions or an amount equal to the vested interest therein, whichever is less, is so invested in life insurance. The remaining portion of the

62. Actually, the death benefit is only equal to the vested interest, and there will only be excess funds if insurance was used in the plan.

63. A corporation may appropriately have forfeitures apply to reduce its contributions under a profit-sharing plan if there is a fixed contribution formula and such a provision is included in the instrument. Such a provision is not mandatory as it is in a pension plan. See Rev. Rul. 61-157, part 5 (d), 1961-2 CUM. BULL. 88-89.

64. See 26 C.F.R. § 1.403 (a)-2 (1954).

65. See Rev. Rul. 61-157, part 5 (c) (1), 1961-2 CUM. BULL. 87-88. Upon attaining the retirement or stated age, each participant must acquire a vested interest in the fund. However, reasonable forfeiture provisions may be allowed to preclude competition or divulging such things as trade secrets.

66. Page , *supra*.

67. Note 25, *supra*.

contribution in either plan may then either be trusteed with a bank for a higher yield or placed with an insurance company as trustee for investment purposes to add security.

Regardless of the choice, the plan is attractive. If an individual Retirement Income Annuity was purchased, all of the contributions would be exhausted should death occur prior to retirement. However, by using the combined plan, all of the proceeds are not tied up in the death benefit, but there is a reasonable interest yield from the insurance if death does not occur prior to retirement. This may best be illustrated by a hypothetical case:

PLAN A.	Employer contributions	$ 300.00
	Cost of Retirement Income Policy	300.00
	Death Benefit	10,000.00
	Fund left if death occurs after ten years	0
PLAN B.	Employer contributions	$ 300.00
	Cost of Ordinary Life Insurance	150.00
	Death Benefit	10,000.00
	Fund left if death occurs after ten years	1,500.00 (plus interest)

In plan A the policy would provide the retirement benefit and desired death benefit, but if an untimely early death should occur, the entire fund is consumed.

On the other hand, in plan B we have provided the desired death benefit, and the cash value of the insurance plus the investment of the unused portion of the contribution, compounded with interest, will provide the necessary funds for retirement. However, should death occur prior to retirement, that portion of the contributions not used to fund the death benefit will not be consumed. These funds then will be available to reduce the cost of the *pension*, or will be allocated proportionately among the surviving participants of the *profit-sharing* plan.[68]

D. STOCK BONUS

Qualified stock bonus plans are good for large, publicly-held corporations, but are of little value to small corporations.

68. Apologies are extended to the actuarial profession for the figures used in the hypothetical. They are by no means representative of anything other than a *very rough* comparison between the cost of Retirement Income and Full Reserve Ordinary life insurance policies.

Such plans are closely akin to profit-sharing plans since there is no fixed retirement benefit. Although the fund is comprised solely of corporate stock, it does not necessarily have to be purchased from corporate profits.

Eligibility requirements are basically the same as pension and profit-sharing plans.

Generally, the corporation will trustee shares of corporate stock based either on a percentage of profits or a fixed dollar investment annually.[69]

Naturally, the size of the trust fund will vary according to the market value of the stock. This value, or book value, is the allowed deduction for the corporation although no actual cash outlay is made.

Stock bonus plans do encourage harder work because a definite ownership in the business is acquired. However, such a plan has many disadvantages. The employee owns *only* stock certificates and nothing more. If such a plan is used to fund retirement, it may well be valueless when needed. Even if there is an excellent "book value" on the stock, it still may be of no value to the employee if the corporation is closely held. The only value would be the right to dividends since there is no market value to such stock, and the directors very easily could destroy the dividend right by increased salaries to management. For these reasons, stock bonus plans have been very little used in this country.

III. GENERAL

A. OTHER ENTITIES

The plans heretofore discussed are limited to corporations but are not limited to *large* corporations.

The widely used "Subchapter S" type of corporation[70] may take advantage of the availability of such plans although such an entity has elected to be taxed as a partnership.[71]

However, partnerships and proprietors, even though they have elected to be taxed as corporations,[72] may not establish a quali-

69. Custodial arrangements may be used in place of trust agreements, however, a bank must serve as custodian. See 26 C.F.R. § 1.401-8 (1954).
70. Small Business Corporations. See INT. REV. CODE OF 1954, §§ 1371-1377.
71. See Vol. XLV (Sec. 2) P-H FED. TAXES REP. BULL. 30, (July 23, 1964).
72. INT. REV. CODE OF 1954, § 1361.

fied pension or profit-sharing plan in accordance with these same rules.[73]

B. ESTATE PLANNING

Even though a lawyer may not be called upon to aid in the establishment of a corporate retirement plan, he should be completely familiar with the affect of such programs on his individual clients.[74]

Every employee who participates in an employee group benefit program of any type has a need for proper counseling on how his estate will be affected thereby.

For example, many corporations provide substantial amounts of group term life insurance for employees which will not continue in force after retirement. In planning an estate, if the client is depending on such benefits to provide adequate estate liquidity to prevent shrinkage due to liquidation, he is realizing a false sense of security. Even if the employee is allowed to convert the insurance to a permanent type of insurance after retirement, the premiums at retirement age usually will be prohibitive.

As an employee approaches retirement age, there is a great need for a complete analysis of his personal affairs and estate.

As previously stated, there may be an option which allows the benefits from the retirement program to be taken in a lump sum or in other modes of settlement.[75]

This privilege will have a tremendous effect on the estate of the individual, and an improper choice at this point could adversely affect not only the retired employee, but his survivors as well.

The biggest advantage to such a program is the systematic guarantee of continued life income to a person who is no longer employed. Unless the participant is independently wealthy and the income guarantee is of no concern, counsel should completely discourage any lump sum receipt of the benefits. A slight market decline or one poor choice of investments could com-

73. INT. REV. CODE OF 1954, § 1361 (d). A partner or proprietor of an unincorporated business enterprise as to which an election has been made under subsection (a) shall not be considered an employee for purposes of section 401 (a) (relating to employees' pension trusts, etc.). This is not to say that these persons can receive no type of retirement program tax benefits, but the rules pertaining to qualification, vesting, deductions, etc. are completely different. See § 401 (c) (1) and the extensive regulations pertaining thereto.
74. See CASNER, ESTATE PLANNING 340-389 (1961).
75. Notes 29-31, *supra*.

pletely wipe out the proceeds, leaving the retired employee without sufficient means with which to support himself and his family. On the other hand, if the proceeds are paid in monthly installments, the retired employee has taken complete advantage of the investment skills and experience of qualified personnel, without worry or cost to him.

Even if the employee is independently wealthy, he should be advised of the net effect on his estate and personal income if he should take his benefits in a lump sum.

First of all, he will pay ordinary income taxes on any *income* received from the plan[76] as these benefits are received. However, if he has attained age 65 he will receive double tax exemptions for himself[77] and will furthermore be in a lower income tax bracket due to his no longer being employed. In addition to these exemptions, he will have the benefit of the joint return if married.[78] These income tax advantages can be greatly beneficial when applied to the income option under a retirement plan.

If, however, a lump sum benefit is elected as retirement, the payee will receive capital gains treatment thereon, but only if there is a *total* distribution of the credits accrued to him.[79] This means that a partial withdrawal will not receive such treatment, but will be treated as ordinary income.[80]

The big factor in aiding the estate problem of liquidity is the tax treatment of the benefits remaining after the death of the employee. If a vested interest is paid prior to retirement as a result of death of the employee, or if there is an interest remaining in the fund at the death of the employee after retirement, these interests will not be included in the estate of the decedent-employee, provided they are not payable to his estate.[81] The only portion of such a fund includable in the gross estate of the decedent will be that portion attributable to the employee's contributions.

Furthermore, if the beneficiaries receive the total distributions payable within one year after the death of the employee, they will pay only capital gains taxes thereon.[82]

76. INT. REV. CODE OF 1954, § 72 and § 402 (a) (1).
77. INT. REV. CODE OF 1954, § 151 (c). For problems encountered as to what is or what is not "termination of service", see Bushman and Buchanan, *Separation from the Service,* 47 A.B.A.J. 738-831 (1961).
78. INT. REV. CODE OF 1954, § 6013.
79. INT. REV. CODE OF 1954, § 402 (a) (1), (2), and (3) (C).
80. INT. REV. CODE OF 1954, § 401 (a) (1).
81. INT. REV. CODE OF 1954, § 2039 (C).
82. INT. REV. CODE OF 1954, § 402 (a) (2).

This can very well be illustrated by a hypothetical case:

Richard Roe, age 65, has been General Manager of the Columbia plan for the ABC Corporation since 1935 and has participated in the corporate profit-sharing plan since its inception in 1938. Upon his upcoming retirement in January, 1965, Roe's interest in the profit-sharing plan will be $300,000.00.

Roe has retired from the United States Air Force Reserves with the rank of Colonel and receives monthly retirement benefits of $300.00 per month therefrom. Roe's only dependent is his wife, and their income from Social Security and other investments will boost their total monthly earnings to approximately $750.00.

Considering his insurance, home, investments and other personal property, Roe has a gross estate of $300,000.00, not including his interest in the profit-sharing plan.

If Roe has a desire to preserve his estate for his surviving wife, it would be foolish for him to take a lump sum payment from the profit-sharing plan.

Should Roe take the lump sum and pay capital gains taxes thereon, he still would have approximately $520.000.00,[83] assuming no growth or depreciation, that would be included in his gross estate at his death. Assuming that it takes approximately 10% to administer the estate, and maximum advantage is taken of the marital deduction,[84] there would be a liability of $42,900.00[85] on the estate for federal estate taxes.

If, however, Roe decided to take an annuity equal to the interest earned by the $300,000.00, his personal income would be increased by that amount[86] and the entire $300,000.00 would pass to his widow without being included in his gross estate.[87]

83. Roughly a 25% capital gains tax on the $300,000.00 from his profit-sharing plan.

84. See INT. REV. CODE OF 1954, § 2056. This section allows up to one-half of the adjusted gross estate to pass to the spouse without being included in the taxable estate of the decedent.

85. This figure is based on a taxable estate of $174,000.00. The rate is $20,700.00 plus 30% of excess over $100,000.00. See INT. REV. CODE OF 1954, § 2001.

86. Assuming a very conservative 3% interest rate, Roe's monthly income from the profit-sharing fund would be approximately $750.00, giving him a total gross income of $1,500.00 per month. This amount could, of course, be increased by taking a larger annuity and yet still preserve a large portion of the corpus.

87. Capital gains taxes will then be paid by the widow if the *total* distribution is made to her within one taxable year after Roe's death. See INT. REV. CODE OF 1954, § 402 (a) (1), (2), and (3).

This means that his gross estate would then be valued at only $300,000.00 and, using the same assumptions as before, his Federal Estate taxes would be only $13,700.00.

Roe and his wife have received a very nice income during his lifetime. They have had safety of principal by leaving the proceeds in the trust fund, and at the death of Roe, $28,200.00 of his estate passes to the widow which would otherwise have been lost by the payment of estate taxes.

IV. CONCLUSION

The complications involved in counseling a corporation as to the best type of retirement program are extensive, and no two situations will be the same. Likewise are the many problems involved in planning an estate of a participant in such a program.

There always has been and probably always will be the problem of insurance agents, accountants, and trust officers counseling in these fields. However, these people can and should perform certain functions in these fields which do not require the practice of law, and they can aid both the lawyer and the client in solving these problems.

One most important factor for the attorney to remember is that in most cases, he will be dealing with highly skilled professionals who are specialists in their respective fields. They can be of great value in planning and establishing these programs for the mutual client.

Although the final responsibility for any and all legal problems involved rests squarely on the shoulders of the lawyer, only by properly teaming with the other professionals involved can the job for the client be accomplished in the most advantageous and efficient manner.

These are resources to be drawn upon, and if properly utilized can tremendously reduce the work involved, while at the same time add much needed brain-power and imagination to an otherwise very laborious one-man task.[88]

With all of these considerations criss-crossing horizontally and vertically through the mind of counsel, there is one last point that should be emphasized.

If counsel already has corporate clients who do not presently have programs such as heretofore discussed, it may be wise to

88. See Hamblen, *A Pre'cis of Deferred Compensation,* PRAC. LAW. 58 (Nov. 1958).

look into the advisability of recommending such a program. After all, such plans as these certainly strengthen the position of local enterprises by alleviating a most important economic and sociological problem, namely our elderly society, at the corporate level. This in the long run will force a curb on federal spending in these areas. If these problems are not solved at the business level, more and more federal control will be exercised and the businesses will pay the cost of such federal programs whether they desire to or not.

When a corporation establishes a qualified plan of its own choosing, the federal government will pay up to one-half of the cost via the corporate tax deduction. This makes for "federal aid" to the retirement plan selected by the corporation and *not* by the federal government.

EUGENE L. BRANTLEY